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SIG-IEP

JAPANESE CAPITAL MARKET LIBERALIZATION AND INTERNATIONALIZATION OF THE YEN

Since this Administration took office, Administration officials have pressed the Japanese to open their capital markets to allow greater foreign participation and increased internationalization of the yen. Although the Japanese have taken a number of steps in this direction, partly in response to U.S. pressure, many restrictions remain, and fundamental steps toward liberalization have not been forthcoming.

Recent concerns about the yen/dollar exchange rate and Japan's growing trade surplus with the United States have exacerbated protectionist pressures in this country, and underscored the need for bold and comprehensive action by the Government of Japan to liberalize their capital markets and allow the yen to become more fully internationalized. Such developments would help ensure that the value of the yen more fully reflected market forces.

Several measures aimed at liberalizing Japan's capital markets are expected to be announced shortly by the GOJ as part of a broader package of measures aimed at stimulating Japanese economic growth and slowing the growth of Japan's trade and current account surpluses. Those measures reportedly will include:

-- liberalization or elimination of restrictions on real estate investment;

-- elimination of restrictions on foreign stock acquisition of certain firms; and

-- announcement of Japanese Government agency bond issues (dollar denominated) in the New York.

While measures of this nature would be steps in the right direction, they would have little impact on the overall investment climate in Japan and therefore must be supplemented by further, more significant steps. Following are two lists of possible additional steps which we could press the Japanese to take in order to accelerate the liberalization of their capital markets and internationalization of the yen. The first list contains those measures to which we might attach high priority for immediate action. The second list contains measures which are also important to the longer-term process of capital market liberalization, but which do not appear to be as important in terms of immediate action. A third list of possible steps which Japan could take in the area of direct investment also is attached for the group's review.

NSC review completed.

The ranking of items within each list is not necessarily according to priority of importance; nor does the fact that an item appears on the second list suggest that it is of less importance than items appearing on the first list. It simply means that those items may be logical candidates for attention over the course of our discussions with the Japanese.

Some of the measures might, if taken in isolation, tend to weaken the yen in the foreign exchange market in the short-term (e.g., the elimination of the queuing system for foreign borrowing in Japan). Other measures, however, (including many of the "immediate priority actions") could tend to strengthen the yen in the short-term. In addition, while some analysts disagree, a strong case can be made that if many of these steps were taken as a "package," and if the GOJ were firmly committed to the opening of its capital markets, such a package would make the yen a more attractive currency.

In the attached lists, we have indicated to the best of our knowledge the current GOJ policies toward the items in question. However, changes in official regulations or policies do not always mean immediate changes in practice. In addition, administrative guidance given by financial authorities to Japanese firms is not always possible to detect, in some cases because the issue is not now active due to market considerations (e.g. there is little interest at this time in foreign borrowing in the Japanese market). As a result, it is not always entirely clear precisely what "current policy" with respect to some items really is.

Immediate Priority Actions by Government of Japan to Liberalize Japanese Capital Markets and Internationalize the Yen

1. Eliminate Japanese tax withholding on interest earnings by all nonresidents. Short of total elimination, seek elimination of tax withholding on Euro-yen bonds and securities.

BACKGROUND: Non-official nonresidents subject to 20 percent withholding tax, except where bilateral tax treaty stipulates otherwise (10% for U.S.). Foreign official interest earnings exempt from withholding. Elimination of withholding would make investment in yen assets more attractive to foreigners.

2. Liberalize regulations on yen-denominated certificates of deposit:

   a) Remove ceilings on total amount of CDs which can be issued by each bank;

   b) eliminate minimum denomination for individual CD;

   c) allow CDs to be freely negotiable.

BACKGROUND: Despite recent increase of ceiling on total amount of CDs which can be issued by each bank to 30% of yen assets for foreign banks (75% of capital for domestic banks), ceilings limit banks' ability to raise yen funds. Minimum denomination roughly $2 million (yen 500 million); to be reduced to roughly $1.3 million (yen 300 million) by the end of 1983. CDs cannot be traded without permission of issuing bank. Raising ceiling and making CDs freely negotiable would make market much more liquid and hence attractive to foreign and domestic investors. Lower denomination would provide greater investment opportunities for small and medium sized investors.

3. Reinforce growing market pressures for liberalization of controls on government debt by following measures: a) issue government

   debt at market-determined interest rates;

   b) encourage further diversification of the maturity structure of official debt instruments, including increased reliance on short term T-bills;

   c) encourage development of an active secondary market;

   d) permit all banks (not just syndicate members) to trade in Japanese Government securities.

BACKGROUND: This proposal would entail a substantial change in current GOJ system of debt management. GOJ debt issued at slightly below market rates only to syndicate of banks and securities firms (Citibank has applied to join and would be the first foreign bank to belong.) Only syndicate members may sell government

debt to the public; foreigners permitted to purchase government securities only upon resale by syndicate members. Secondary market activity limited due to requirement that underwriting syndicate hold debt 100 days before resale. (More active secondary market could develop as ten-year debt issued in 1975 nears maturity.) T-bills now issued on a limited basis, primarily for cash management purposes, and must be redeemed within fiscal year of issue.

GOJ debt concentrated in ten-year instruments, although steps have been taken in recent years to diversify maturities. GOJ reportedly considering further diversification of official debt beginning in 1985, when ten-year debt issued in 1975 must be rolled over and a large amount of new debt issued as well.

GOJ not likely to accept nonsyndicate trading in government securities, since it would undermine the current system of government debt management.

4. <u>Action by GOJ to make membership of the Tokyo Stock Exchange economically feasible for foreign securities firms by reducing the security deposit requirement</u>.

BACKGROUND: Although foreign firms have technically been permitted for over a year to join the Tokyo Stock Exchange, the financial commitment required (roughly $5 million in cash) makes membership economically unfeasible for foreign firms. (No seats are currently available, but the GOJ would almost certainly "find" one if a U.S. firm were interested.) A seat costs roughly $1 million; the remaining $4 million is a required security deposit to ensure the firm can meet its obligations. U.S. firms, already subject to SEC minimum capitalization requirements, would thus have to bear a double burden.

In contrast, Japanese firms can readily join U.S. securities exchanges because financial commitment is the cost of the seat, appropriate bonding (security deposit in cash not required), and maintaining capitalization of U.S. subsidiary at or above minimum SEC levels. GOJ should take account of capitalization requirement in the United States and other foreign countries in setting level of security deposit for foreign firms.

5. <u>Extend 73% commission rebate on Japanese securities traded in Tokyo to foreign securities firms with representative offices in Japan</u>.

BACKGROUND: All non-members of the Tokyo Stock Exchange must pay a commission for execution of trades on the exchange. Current securities industry rules allow rebate of 73 percent of commission only to foreign firms with branches in Japan. Extending rebate to foreign firms with <u>representative offices</u> as well vitally important; would enable them to compete more effectively with Japanese firms in selling Japanese securities, especially in the United States, thereby facilitating foreign investment in Japanese securities.

6. Take decisive steps to liberalize and encourage the development of forward foreign exchange markets.

BACKGROUND: Use of the forward exchange markets currently limited

to underlying real transactions such as trade. Liberalization and development of forward market could enhance willingness of investors to purchase and hold yen.

7. Public GOJ statement that it desires increased denomination of Japanese exports in yen. GOJ also could encourage Japanese trading companies to hold a significant portion of their working balances in yen, not dollars.

BACKGROUND: Currently between thirty and forty percent of Japan's exports are denominated in yen (up sharply in recent years) and only two to three percent of imports. Increased yen denomination of Japan's exports would eliminate exchange risk for Japanese exporters and could stimulate use of the yen in international trade and finance, although it could face some resistance by importers (including U.S.) reluctant to deal in yen.

8. Make official statement confirming that foreign firms are permitted to lead manage foreign security/bond issues in Japan.

BACKGROUND: All U.S. firms with branches in Japan are licensed to do so, but tradition and their small size have prevented them from being lead managers. (One U.S. firm in 1982 co-lead-managed a yen issue in Japan by a U.S. corporation.)

9. Publicly reaffirm past statements that applications for branches of foreign securities firms will be processed expeditiously.

BACKGROUND: Application process remains tedious (can take over a year) despite government efforts to make it simpler (by such means as setting up "information offices" last year). Periodic prodding by the U.S. Treasury still necessary to facilitate application process.

10. Authorize establishment of off-shore banking facilities for yen and foreign currencies, similar to the International Banking Banking Facilities (IBFs) recently established in New York.

BACKGROUND: Current Japanese policy implicitly prohibits establishment of such facilities, although there has been no official statement on the question. Governmental support for establishment of such facilities could be an important step in overall internationalization of the yen, affording foreign investors an opportunity to purchase, borrow and lend in yen free of interest rate controls, reserve requirements, etc.

11. USG indication to GOJ that USG would support borrowings by GOJ agencies in New York or other overseas capital markets.

BACKGROUND: Initial GOJ agency borrowings likely to be announced as part of October economic package. Although direct market effect on yen/dollar rate likely to be minimal, could have psychological effect on foreign exchange markets, strengthening the yen.

12. GOJ action to accelerate interest rate liberalization on all instruments, including bank deposits and postal savings deposits.

BACKGROUND: Ceilings exist on bank savings and postal savings accounts, although most short-term lending rates are market determined. Most long-term rates are administered. Removal of interest rate ceilings could make yen deposits/investments more attractive for both Japanese and foreign investors.

13. Permit foreign lawyers and other professionals to practice in Japan.

BACKGROUND: While this is not a "capital market liberalization measure" *per se*, it could significantly facilitate foreign investment in Japan. Current regulations effectively prevent foreign lawyers from practicing in Japan. Changes in these regulations could make it easier for foreign investors and businesses to do business in Japan, thus helping draw capital

Longer-Term Priority Actions by Government of Japan to Liberalize Japanese Capital Markets and Internationalize the Yen

1. Eliminate nonprudential aggregate limits on banks' overseas lending in yen and foreign currencies.

   BACKGROUND: MOF "guidance" for April-September, 1983 period is about $3 billion in yen lending and about $8 billion in foreign currency lending. Removing the ceiling on yen loans would facilitate foreign, e.g. U.S., borrowers' access to yen financing and generally facilitate the internationalization of the yen. (At present there is little foreign interest in borrowing yen in light of the expectation that the yen will strengthen, though this could change with a stronger yen.)

2. Remove limits on foreign banks' "swap" positions, unless needed for prudential purposes.

   BACKGROUND: BOJ sets limits on each bank's ability to "swap in" funds by selling dollars for yen in the spot foreign exchange market and making an offsetting purchase in the forward market. Thus, ability to "swap in" funds provides another, possibly lower cost, funding alternative for foreign banks, enabling them to compete more effectively in making yen loans. Increases in "swap" limits recently granted on the basis of past utilization. Removal would contribute modestly to promoting market determination of interest rates by increasing links with foreign capital markets. Would also increase foreign banks' yen lending activities. (Increased swap limits for foreign banks would put them in a preferential position vis-a-vis Japanese banks, which are subject to strict position requirements.)

3. Relax collateral and other requirements that may appear to discriminate against foreign borrowers.

   BACKGROUND: Japanese security issues are traditionally on collateralized basis, which U.S. firms cannot do because of covenants in existing debt indentures. Present standards for issuing on an unsecured basis in terms of net worth, assets, and income so stringent few U.S. firms would qualify. As a practical matter, exceptions have been made to enable U.S. corporations to issue in Japan -- which has in turn led to pressure for easing the standards for Japanese issuers as well -- but the standards are still officially in effect.

4. Establish an independent stock/bond rating system for Japanese securities.

   BACKGROUND: Would facilitate issuance of securities on a non-collateralized basis and familiarize Japanese investors with concept of ratings rather than collateral, making them more receptive to U.S. securities.

5. Permit all Japanese residents to maintain yen and foreign currency accounts with overseas banks and securities firms.

BACKGROUND: Except for roughly fifty major financial institutions, Japanese residents are prohibited from doing so. Would be an extremely important step in removing capital controls by removing a key control mechanism. Would also facilitate capital flows and permit foreign firms without branches in Japan to compete for business currently going to Japanese firms.

6. Make public statement that foreign financial institutions can become members of relevant trade associations in which decisions affecting their business are being made.

BACKGROUND: While decision is up to trade associations, who do not welcome foreign competitors, public statement by GOJ could facilitate membership of foreign firms. While foreign firms can become full members in some cases, in others they are only allowed to participate informally. For example, American Express is now allowed (after USG intervention) to participate in informal group drawing up specifications for credit cards, but it is not a full member. Important to establish principle that foreign firms can join; as a practical matter, U.S. banks are now full members in clearing house and automated data exchange.

7. Make a public statement indicating that securities denominated in foreign currencies may be freely issued in the Japanese market.

BACKGROUND: Bonds denominated in foreign currencies have been issued in the Japanese capital market in the past, although none has been issued in the past three or four years. Would strengthen role of market forces by providing another investment alternative.

8. Make public statement that Japanese firms are free to use foreign investment banks when issuing securities overseas.

BACKGROUND: No formal requirement, but issues of Japanese corporations now invariably led or co-led by Japanese securities firm. (Until five or six years ago, U.S. investment banks led all dollar-denominated Eurobond issues of Japanese corporations, and then all at once every such issues was led by a Japanese firm.) Informal MOF "advice" to firms to include a Japanese securities firm in a leading role provides another mechanism for controlling financial activities of Japanese firms abroad.

9. Permit foreign certificates of deposit and commercial paper to be traded in Japan.

BACKGROUND: Decision to allow this announced over a year ago. Implementation still awaited, pending strengthening of the yen. Would be another step towards liberalizing Japan's capital markets (by providing another investment alternative) and facilitating international capital movements.

10. Eliminate queuing system for foreign firms and governments wishing to borrow in Japan.

BACKGROUND: Size of individual public issues limited to $45 to $90 million, and securities industry "consults" with MOF to avoid market "congestion." Relatively unimportant now, due to low level of foreign interest in yen borrowing, but could become crucial when such interest reappears.

11. Inform GOJ that U.S.G. would support GOJ's efforts to permit GOJ to issue debt instruments overseas, both in yen and in foreign currencies.

BACKGROUND: Currently under considerabion by the GOJ. Issuing debt abroad currently prohibited by law. Would enable GOJ to issue securities abroad in its own right rather than only through agencies. While actual effect on the yen would depend on the size of the issues, psychological effect (strengthening the yen) could be more significant.

Priority Actions by Government of Japan to Liberalize Direct Investment

1. Amend the investment notification and approval provisions of the Foreign Exchange and Foreign Trade Control (Forex) Law to:

   a) eliminate 30 day waiting period, moving to a post-investment notification system for both new investments and expansion of existing investments

   b) exclude ministries other than Finance

   c) eliminate criterion relating to adverse effects on Japanese enterprises or the national economy

BACKGROUND: The Forex Law requires investors to notify proposed investments to the Ministry of Finance 30 days prior to the investment. If MOF or other concerned ministries do not object to the investment or call for alteration of the proposal, the investment may proceed as planned. These amendments should remove some uncertainty and confusion that may be created by the current system. Items b and c would narrow the scope for GOJ review of investment applications.

The GOJ is likely to claim that the notification process does not hamper foreign investment, but may consider some modification.

2. Eliminate "designated company" method of limiting foreign ownership; also take other actions to facilitate acquisition of financial and non-financial enterprises.

BACKGROUND: GOJ has authority to limit total foreign investment in "designated companies" in four industries (agriculture, oil, mining, and leather) and in other firms on national security grounds (e.g. atomic energy). Elimination of the designated company list may be included in the October economic stimulus package. Other steps may be more difficult to achieve.

3. Reaffirm publicly that access to government procurement opportunities, R&D funding, industry rationalization schemes and similar programs are open to foreign-owned firms on a national treatment basis.

BACKGROUND: GOJ indicated at recent bilateral investment consultations (October 13 and 14) that it will implement Forex Law according to OECD principles and thus will extend national treatment to foreign investors. Similar language also appears in new bilateral High Technology Agreement. GOJ should be willing to agree to this request.

Issue clouded, however, by uncertainty over precise meaning of "national treatment". GOJ now discriminates among domestic firms in programs listed above; will GOJ also discriminate among foreign firms? Does USG support or approve of such discrimination, even if it implies national treatment?

4. Increase the transparency of Japanese investment regulations, clearly delineating all steps necessary to make an investment in all sectors.

BACKGROUND: The Japanese Export Trading Organization (JETRO) has issued publication, "How Can Foreign Affiliates Succeed in Japan", which outlines some of the procedures to follow in investing in in Japan. GOJ might be willing to consider a more detailed publication.

5. Take "affirmative action" measures to facilitate foreign investment.

BACKGROUND: GOJ might argue that former Prime Minister Suzuki stated publicly that Japan welcomes foreign direct investment. However, GOJ may accept the idea of other types of affirmative action, such as creating an office of investment ombudsman.